

DDI Testimony Before the Subcommittee on
International Trade, Finance, and Security Economics of
the Joint Economic Committee, Congress of the United States

The Soviet Economy

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I. Mr. Chairman, in inviting us to testify on the Soviet economy, you asked that we focus on economic policy changes under the new leadership and the significance of those changes. economic performance in 1982 and thus far in 1983, and the outlook over the next few years. You also requested that we discuss trends in the Soviet Union's allocation of resources to defense. ☐

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A. Let me start with economic developments in the past two years. Last year and the year before, growth in Soviet gross national product (GNP) averaged about 2 percent per year, somewhat above the level attained during 1979-80 but well below both the rate achieved during the 1970s and the rate implied by the 1981-85 Plan (figure 1). ☐

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B. The slowdown in the growth of industrial output was especially worrisome. ☐

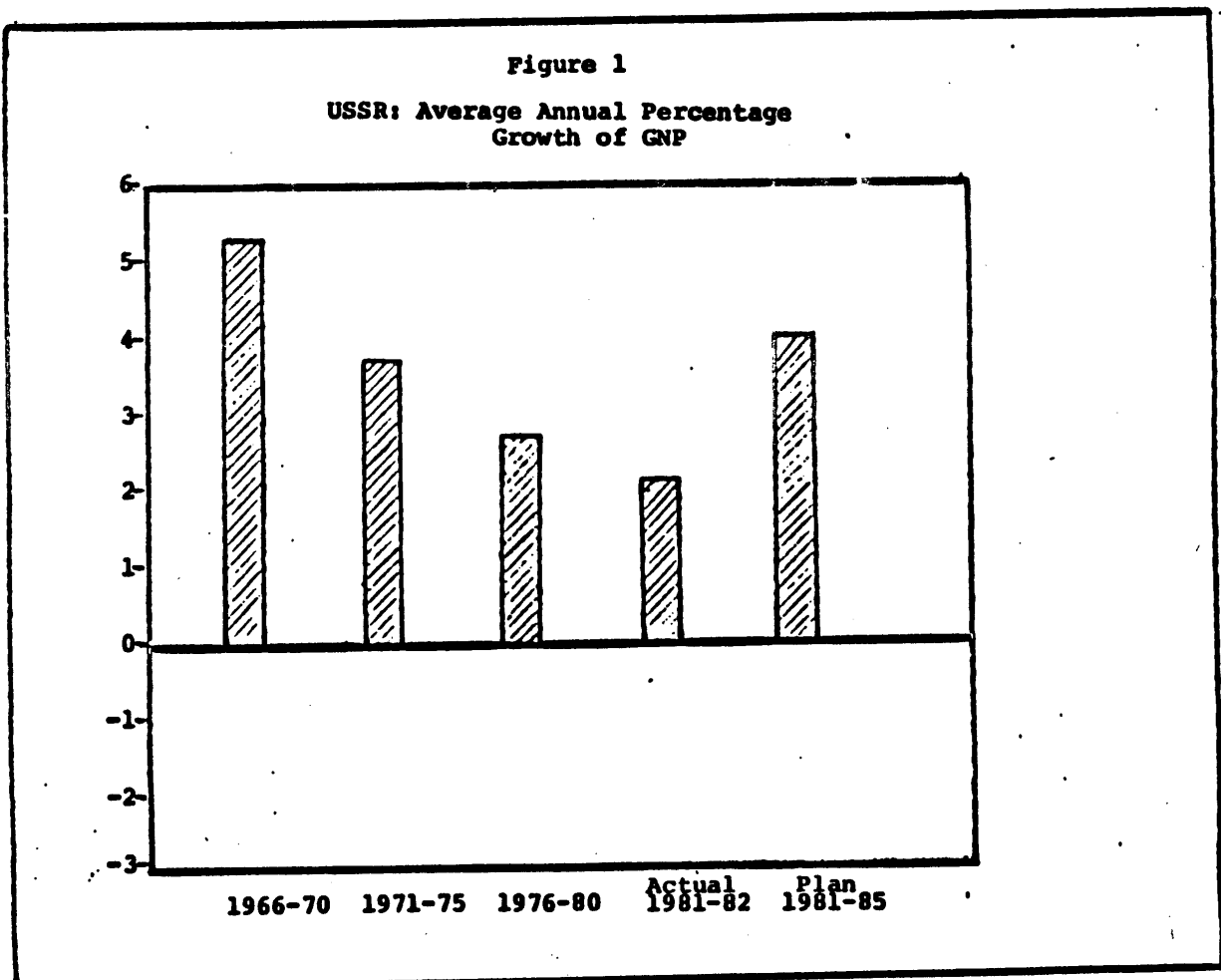
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1. In 1981-82, average annual growth was less than 2 1/2 percent, about half the rate called for in the 1981-85 Plan. ☐

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DIA review completed. ☐

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2. Two developments during this period were particularly noteworthy: the slowdown was evident in practically every industrial branch, and the productivity of labor and capital employed in industry was down dramatically.

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C. Within industry the growth of energy production in the USSR has decelerated significantly.

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1. While gas output grew rapidly in 1981 and 1982, raw coal output increased in 1982 for the first time since 1978.

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2. After three decades of growth, oil production in the USSR has begun to level off, although the prospects for the future are considerably better than we once believed.

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D. Based on some extensive research over the past two years, we now estimate that the combined output of oil, natural gas, and coal will increase by 10 to 12 percent in 1981-85 compared with the 22 percent achieved in 1976-80. In the latter half of the decade energy production will be about 6 percent greater than in 1981-85.

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1. Oil production probably will plateau by the middle of this decade and then subside slowly through 1990.

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2. All things considered, the energy picture implies much less of a constraint on growth of the domestic economy than we thought last summer.

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- E. Shortfalls in the general availability of raw materials were a major reason for the marked slowdown in industrial production in 1981-82 (figure 3).

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1. Declining growth in production of coal and its deteriorating quality, for example, hurt electric power and ferrous metallurgy. Shortages of electric power, in turn, impaired the performance of industrial power customers, and an insufficient supply of steel products contributed to lower growth in machinery production.
2. The low rate of growth of machinery output--only 3.2 percent annually during 1981-82--is about half the rate planned for 1981-85 and by far the lowest since World War II.

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Figure 3

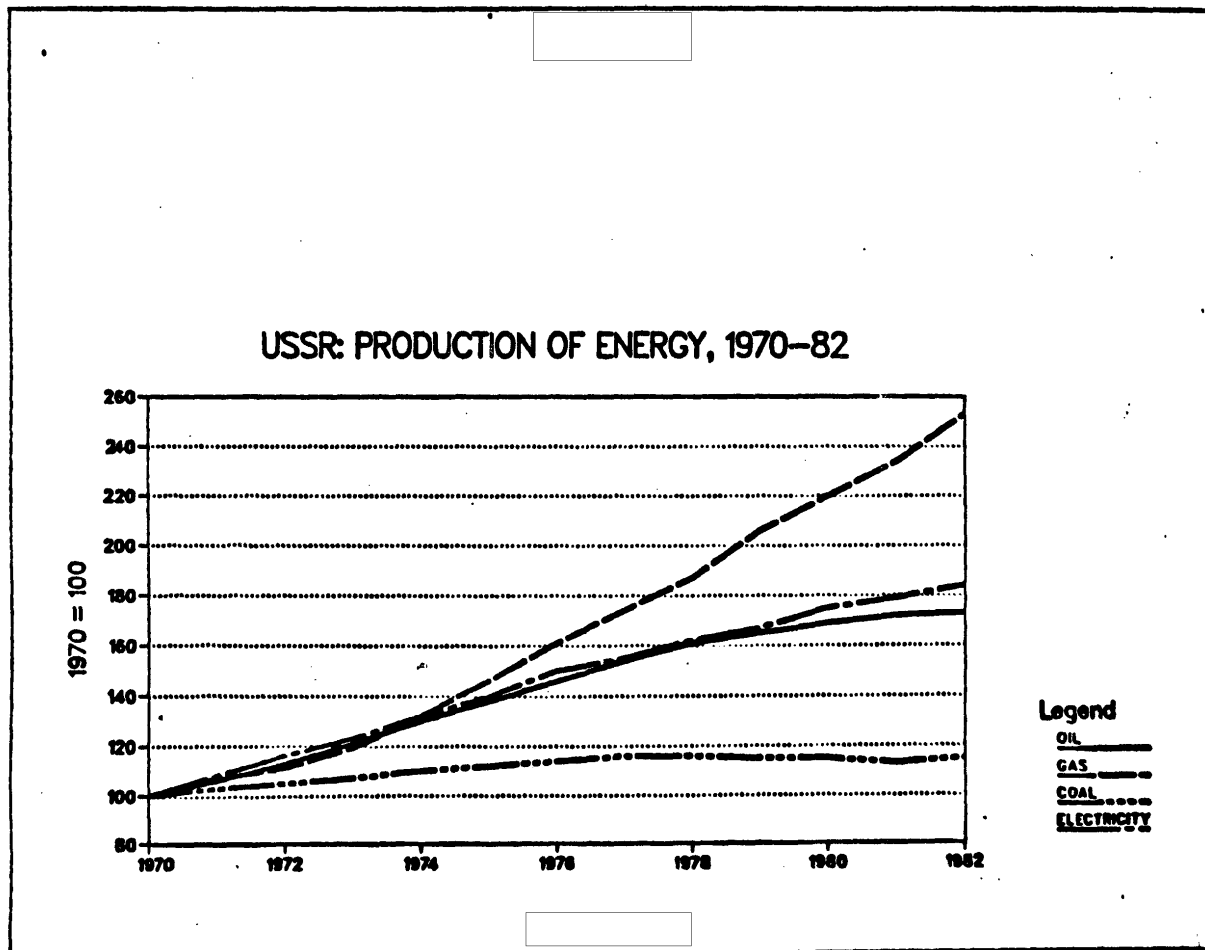
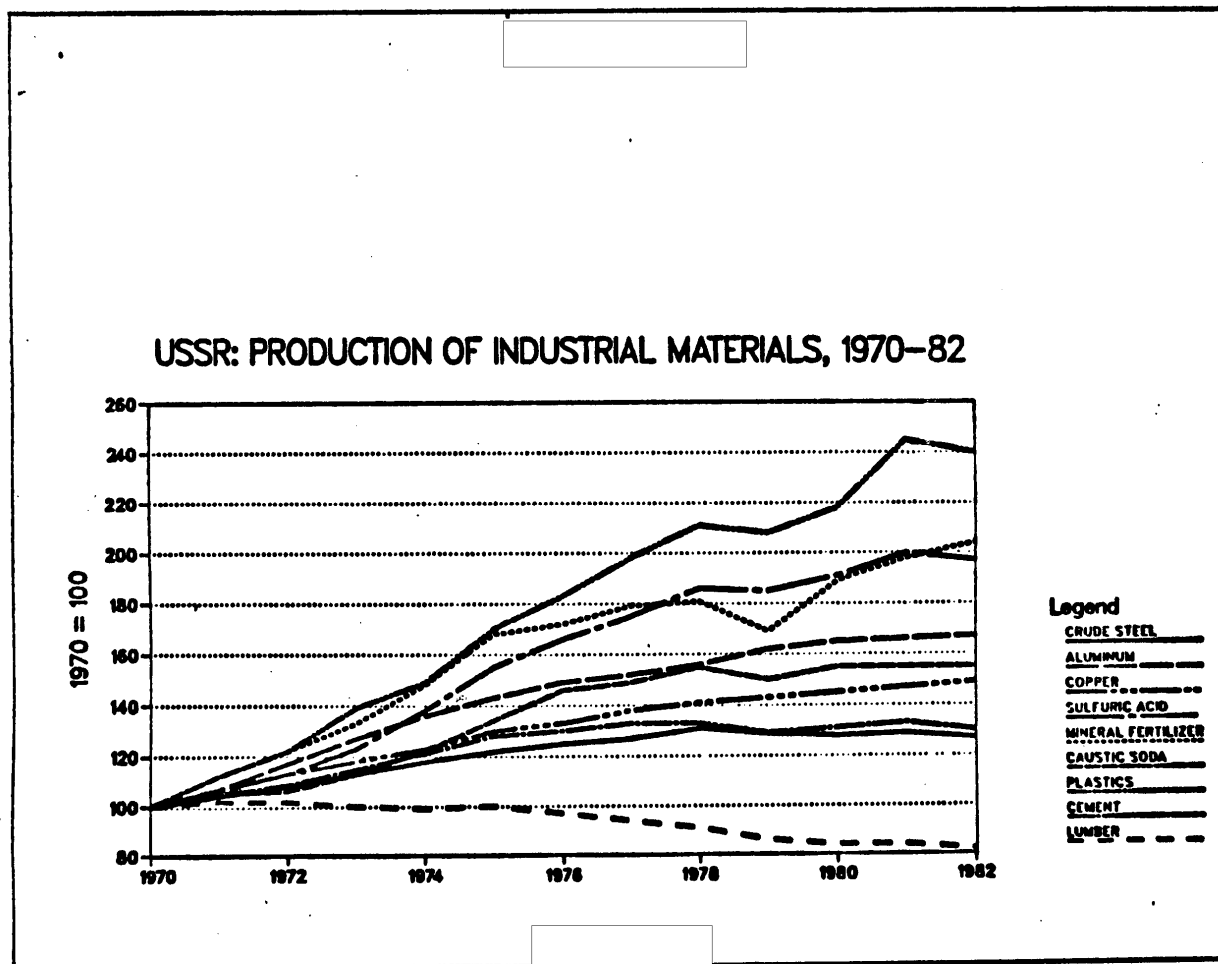


Figure 3 (cont.)



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3. Machinebuilding is a pivotal sector, producing military hardware as well as consumer durables and machinery for investment. The hard choices on resource allocation facing Andropov are most evident in the sector.

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F. The value of agricultural output, almost the same in 1981 as in 1980, increased by somewhat more than 3 percent in 1982.

1. We estimate grain production at 165 million tons last year--an increase of 7 million tons over 1981 but some 70 million tons short of plan.

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2. Even with the 1982 rebound, farm output was still nearly 7 percent below the 1978 peak-year level.

G. A substantial share of the responsibility for the falloff in industrial growth must be assigned to bottlenecks in the transportation of both raw materials and finished products.

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1. Total freight turnover, which had increased at an annual rate of 3.5 percent during 1976-80, actually fell slightly last year.

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2. The principal culprit has been the railroads, which shoulder the major part of the transportation burden in the USSR.

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- H. As Andropov noted in his early speeches, much remained to be done in the in the area of consumer welfare when he took office.

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1. According to our estimates, total per capita consumption increased in 1981 by about one percent--but then declined in 1982 by almost one percent.

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2. Meanwhile, the availability of quality foods declined generally. Per capita meat consumption, for instance, was down slightly in 1982 from its peak 1979 level.

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- I. In another area, the Soviets had more success. The USSR substantially improved its hard currency payments position in 1982.

1. By strongly pushing oil exports and holding down imports, the USSR slashed its hard currency trade deficit to \$1.3 billion, or one-third of the deficit incurred in 1981.

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2. By the end of the year, gross hard currency debt had fallen by an estimated \$800 million and totaled \$20.1 billion. Assets in Western banks were a record-high \$10 billion at the end of last year.

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II. Mr. Chairman, I have just reviewed the general performance of the Soviet economy during the last two years. Let me now turn to the particular issue of the costs of Soviet military programs.

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view → A. As we noted in our submission to your subcommittee, our latest estimate indicates that Soviet outlays in constant prices have leveled off since 1976 in at least one major area, procurement of military hardware (figure 4).

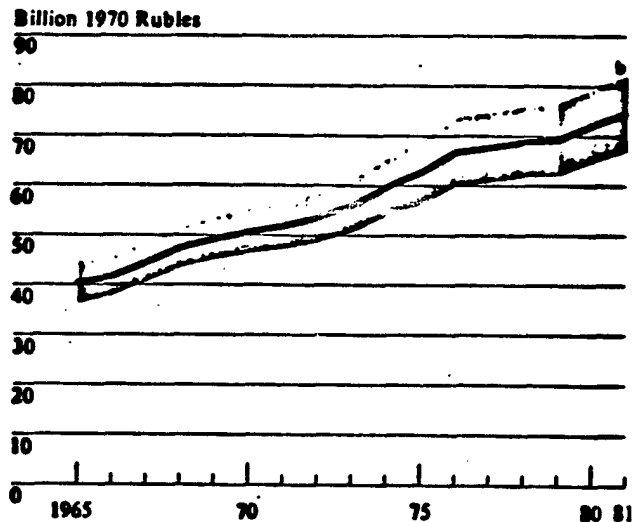
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1. Costs in all other categories of Soviet defense continued to grow at historic rates over the entire 1972-81 period. Operations and maintenance costs, for example, grew by 3-4 percent annually; personnel costs increased by slightly less than 2 percent a year.

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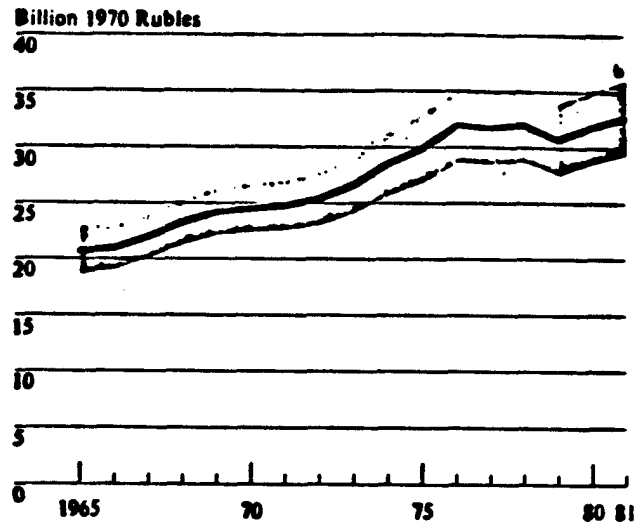
2. Our new estimate, however, shows that like overall economic growth the rise in the total cost of

Figure 4

USSR: Estimated Defense Expenditures, 1965-81^a

^aThe shaded area represents the confidence interval for each year's estimate of total defense expenditures. The width of the interval changes over time as the weight of the component estimates that make up the total and our confidence in them vary. We believe there is less than a 10-percent chance that the true figure for any given year lies outside this interval.

^bIt should be noted that our estimates for 1980 and 1981 are heavily influenced by lead costs associated with weapons expected to be completed in the succeeding two to three years. As we collect additional information on activities in those years, changes could result.

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[redacted]

defense since 1976 has been slower--about 2 percent a year. [redacted]

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3. As General Bissell indicated in his June testimony, DIA estimates of weapons production also show flat or declining trends for major categories since the midseventies. But their estimate of Soviet defense spending--which includes inflation--shows substantial growth in total defense and procurement costs, though at a somewhat slower rate since 1976. [redacted]

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B. The continued slow growth since 1970 seems related to a combination of complex factors including technological problems, industrial bottlenecks, and policy decisions: [redacted]

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a. We know that a number of major Soviet weapons ran into technical delays that pushed their serial production back at least a few years. [redacted]

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b. Raw material, energy, and transportation bottlenecks appear to have disrupted military production just as they did civilian production during this period. [redacted]

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c. The leadership, either anticipating these problems or in response to them, may have taken steps to stretch out military procurement.

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d. Decisions to comply with SALT I and the unratified SALT II treaty also may have slowed procurement in certain areas.

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e. I should note, however, that the costs of current Soviet military activities is very large--about 45% greater than US procurement costs for 1981. Despite the procurement plateau observed, the Soviet forces have received some 2,000 ICBM and SLBM missiles, 6,000 tactical combat and interceptor aircraft, 65 SSBN and attack submarines, and 31 major surface combatants since 1975. Thus, even with reduced growth, they could still introduce many new systems and continue to improve their forces throughout this decade.

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III. As the first two years of the 1981-85 Plan neared completion, it must have become clear to Soviet leaders that their economic strategy was not working. Nonetheless, on the basis of information published on the 1983 plan and what has happened since, we conclude that

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III. As the first two years of the 1981-85 Plan neared completion, it must have become clear to Soviet leaders that their economic strategy was not working.

Nonetheless, on the basis of information published on the 1983 plan and what has happened since, we conclude that Andropov is still basically holding to the course set by Brezhnev.

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A. In particular, the little evidence that is available indicates Andropov has not accelerated Soviet military spending.

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B. There also are no indications of significant change in agricultural policy since Andropov took power.

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1. The priority the leadership has given the Food Program mirrors an apparent high-level preoccupation with living standards.

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2. Aside from its agricultural policies, the new regime has shown concern for the welfare of the population by a flurry of decrees published this year which call for more attention to consumer-related programs.

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3. Nevertheless, the regime has little room for maneuver on consumer issues until the Food Program

pays some return and until more investment can be spared for the production of soft goods and consumer durables.

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C. The major new element of economic policy this year is the discipline campaign.

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1. Andropov does not believe that greater discipline alone will cure the economy's ills, but he sees it as a necessary beginning.

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2. Although the campaign is designed to tighten discipline all around, the campaign so far appears to be directed primarily against blue-collar workers.

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D. In the more sensitive area of reforming planning and management, the new regime has introduced only some very limited measures designed to decentralize decisionmaking in both industry and agriculture. These are described in some detail in our submission.

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IV. Turning now to the outlook for 1983, we believe that some of the economic pressures on the Andropov leadership should ease slightly this year.

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A. Based on statistics available for the first seven months of 1983, we estimate that GNP will rise by 3.5 to 4 percent--well above the approximately 2-percent rate of growth achieved in both 1981 and 1982.

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1. All major sectors of the economy are doing better this year.

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2. The rebound in industry reflects a comparison with an exceedingly poor first half 1982. It also owes much to the better than normal winter and spring weather conditions, which eased transportation blockages and permitted some rebuilding of stocks of fuels and other inputs less in demand when the weather is mild.

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3. We estimate that industrial production will grow about 3 percent this year, somewhat more than the 2 1/2 percent annual rate in 1981-82.

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B. Following four consecutive years of poor agricultural performance a substantial recovery is in the cards in 1983.

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1. We expect total farm output to increase by about 7-8 percent, compared with slightly more than 3 percent in 1982 and almost no growth in 1981.

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2. Barring a major deterioration in weather conditions, a grain harvest of 210 million tons is likely, the best crop since the 1978 record of 237 million tons. The outlook for other major crops is also good. []

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C. On the other hand, the new regime, which apparently came to power with the support of the military, may well be under pressure to speed up defense spending. [to counter a resurgent Western military effort.] []

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1. Opening the spigot wider would be costly. Any sharp acceleration of the level of military procurement will make it much more difficult for Moscow to solve its general economic problems.

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2. Andropov must soon decide how to approach the defense spending and resource allocation issue because the planning cycle for the 1986-90 Plan is already under way. []

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V. A stronger economic showing this year would help Andropov politically, but it would not--in our view--foreshadow a higher growth rate over the longer term. As we say in the submission you have received, the problems that have constrained growth since the late 1970s have not gone

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away; some of them, in fact, are just now reaching peak severity. ☐

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A. Most important, because of the slower growth of labor and capital expected in the remainder of the 1980s, long term growth would have to be sustained by increases in the combined productivity of labor and capital. A turnaround in productivity trends is not likely, however, without fundamental change in the economic system and until worker incentives are improved. ☐

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B. But the regime's present strategy for spurring efficiency seems unequal to the task. ☐

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1. For example, long cultural conditioning in the work force and the difficulty of reversing trends entrenched for the last 20 years will present substantial obstacles to broad use of increased wage differentials to stimulate productivity. ☐

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2. Serious obstacles also stand in the way of continued implementation of the discipline campaign. Public tolerance of a tough discipline drive 30 years after Stalin is likely to be tenuous and transitory. In the current labor market, moreover, management will be reluctant to

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crack down on workers, who can easily quit and
find jobs elsewhere, often at higher pay.

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C. The regime could improve the performance of the
economy in a number of ways.

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1. The current investment plan, for instance, is
lopsided and lacks balance; it stresses
development of energy and agriculture at the
expense of other sectors also vital to economic
growth.

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2. A greater return could probably be achieved by
shifting more investment to such sectors as
machinebuilding, transportation, and ferrous
metals. In this connection, holding down growth
in defense spending would free up resources that
could be used to bolster the civilian economy.

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3. Some gains could be achieved also by identifying
those areas in the economy where mismanagement and
administrative efficiency are worst and replacing
the managers responsible at all levels with more
competent people.

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D. The greatest potential for reviving economic growth, however, lies in more "radical" measures that would alter Soviet economic mechanisms. ☐

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1. The major constraint, however, in changing the Soviet economic system is that Andropov and the rest of the leadership--for compelling cultural, economic, and political reasons--will not dismantle the command economy and replace it with some form of market socialism. ☐

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2. Given Andropov's emphasis thus far on study and small-scale experiments, we think that reforms of organization and management will have little impact on the economy during the next several years. Indeed, the improved performance in 1983 may even reduce the pressure for economic change in the short run. ☐

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The Chinese Economy

Now, Mr. Chairman, I would like to conclude my summary remarks with a review of recent developments in the Chinese economy.

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I. The Chinese economy today is in much better shape than it was just a few years ago.

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A. Progress can be seen in the substantial improvements in personal incomes and consumption, in the remarkable growth in agriculture, and in the expansion of foreign trade.

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B. There is now a sense of direction and purpose to economic policies.

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1. The new Sixth Five-Year Plan (1981-85), approved last December, provides a reasonably well-defined policy framework, something that had not existed since the 1950s.

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2. During the Cultural Revolution (1966-76) China's planning apparatus was dismantled and plans reportedly consisted of little more than targets for a few important commodities.

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II. In several respects, however, economic progress has proved elusive.

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A. The appalling waste and inefficiency that characterized the Chinese economy in the 1970s remains equally serious today.

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B. Paradoxically, management reforms designed to reduce waste--by strengthening the profit motive and decentralizing financial decision making--have also made it more difficult to complete urgently needed projects in bottleneck sectors such as energy and transportation.

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1. Last year, the investment plan called for only a nominal increase in capital construction; by the end of the year, actual spending was up by over 25 percent. Almost half of the increase came from unplanned spending by enterprises, financed from retained profits permitted under new government rules.

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2. This surge in investment, as in 1980, stretched existing supplies of scarce building materials and made it more difficult to guarantee cement, steel, glass, and the like to priority projects.

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C. This failure to meet completion targets for critical energy and transport projects is at the center of current policy discussions in Beijing. Only slightly less important is how to ensure further improvements in living standards and consumption in the face of large investment requirements.

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III. 1982 was fairly typical of recent years.

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A. Overall, economic growth was at least moderate-to-good.

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1. GNP and industrial production each rose by over 7 percent.

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2. Energy production rose by 5.7 percent, easing what still is the major constraint on growth, while agricultural output, benefitting from favorable weather and a continuation of liberal policies, grew by a remarkable 11 percent.

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3. Despite the fact that increases in personal incomes were slightly smaller than in 1981, Beijing still had problems providing adequate supplies of consumer goods.

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4. Chinese consumers, not finding what they want in the stores, continued to deposit large sums of

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money in savings accounts; and inventories of rejected merchandise continued to pile up.

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5. The population was also faced with a rise in urban unemployment, which perhaps reached 10 percent, and an inflation rate of between 5 and 10 percent.

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B. At the end of 1982, China was in its strongest international financial position ever. Foreign exchange reserves stood at over \$11 billion, more than double the year-earlier total.

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1. Most of the increase in reserves, however, came as a result of cuts in imports, which fell by 10 percent. With exports growing by over 3 percent, the trade surplus reached \$6.3 billion.

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2. Import cuts also had an impact on Sino-US trade. China continued to run a deficit, although that deficit shrank in 1982.

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a. A 21-percent increase in Chinese exports combined with a 19-percent decline in their imports reduced China's trade deficit with the US from \$1.7 billion in 1981 to \$0.6 billion last year.

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b. Chinese sales of textiles to the US were up 34 percent, and their purchases of US grain were up 5 percent on a volume basis. ☐

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c. A 60-percent decline in imports of textile fibers seems to have been unrelated to the Sino-US textile dispute. It appears instead to have been a matter of the Chinese having excessive inventories of fiber. ☐

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IV. The first half of 1983 has seen a continuation of some of the more unwelcome developments of 1982. ☐

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A. Investment spending has continued to grow at a 20-percent pace, prodding the regime to review the construction program and to halt or drop lower-priority projects. ☐

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B. Too-rapid growth in heavy industry continues to squeeze consumer goods production. ☐

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1. During the first six months of this year, heavy industrial output rose by 12.2 percent over the year-earlier period. The annual target is 3.9 percent. ☐

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2. Light industry grew by only 5.4 percent. ☐

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V. Earlier, I mentioned management reforms.

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A. Since the late 1970s, China has experimented with management reforms in practically every sector of the economy.

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1. The basic thrust has been to decentralize decisionmaking in an attempt to boost production and efficiency.

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2. The reforms in agriculture have shown the most striking success.

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a. Essentially, these reforms have entailed a reduction of the government's role in production and marketing decisions. Now, in most places, most of these decisions apparently are made by farm households or even individual farmers.

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b. We believe these changes have been very important in agricultural growth since the late 1970s. But--and this is a major complication--Beijing has also raised prices for agricultural products. This by itself probably has been a considerable stimulus.

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3. In industry, the reforms have involved strengthening the profit motive and allowing enterprises to retain a portion of their profits.

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a. Intuitively, this type of reform is appealing, but because of major irrationalities in China's price system, the changes have not produced the desired effects.

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b. The reforms, moreover, have also provided the funds for enterprises to carry out additional investment, resulting in the overextended construction program mentioned earlier.

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4. In another interesting reform, Beijing now permits individuals to open their own businesses, in some cases extending loans and allowing them to hire workers, usually only three or four who are designated "apprentices."

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a. This more liberal stance on individual enterprises has been a very practical one for two reasons: large unemployment and the

extreme scarcity of personal service personnel--such as barbers and appliance repairmen, among others.

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b. On the whole, individual enterprises still are not terribly significant for the Chinese economy. But they have grown rapidly. In 1978, there were only 150,000 individual laborers in the urban areas; by the end of 1982, there were 1.5 million--rapid growth by any standards.

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5. Other reforms include: increased use of domestic bank loans for investment funds; raising interest rates to allocate investment more rationally; encouraging direct contact between producer and consumer; allowing some product sales at prices that differ from state-set prices; and promoting "free markets" to allow peasants to sell their produce in urban and rural areas.

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B. The examples I have cited perhaps give you an idea of the type of reforms the Chinese are interested in. At this stage, judging their net impact on economic performance is very difficult.

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1. Currently, Beijing has adopted a more cautious approach to economic reform.

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2. But because there are so many day-to-day problems that demand attention, and because they want to give more thought to the reform program, the Chinese leadership has postponed further major changes in the system until sometime after 1985, the end of the current five-year plan.

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